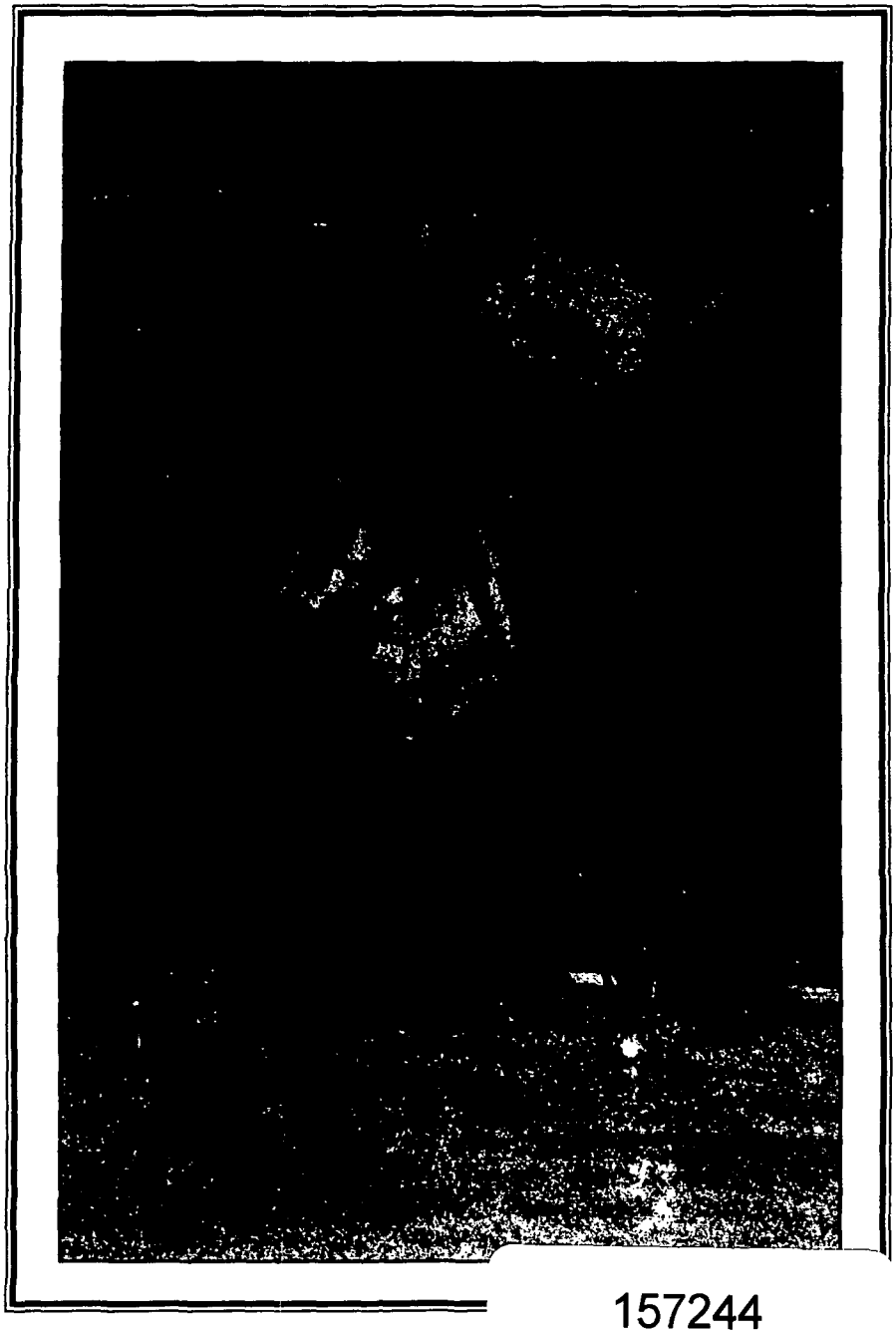
Piercing the Corporate Veil Under Texas Law

By J. Thomas Oldham



Various causes of action exist whereby an owner of a corporation may be personally liable for a claim against a corporation. For example, if an owner personally guarantees an obligation, personal liability obviously is possible. Also, when negotiating a transaction, if an owner does not clearly notify a third person that the responsible party will be the corporation, not the owner individually, the owner can be personally liable under theories of partially disclosed or undisclosed principal.[1] In addition, an owner who participates in a tortious act[2] or an environmental infraction[3] committed in connection with the business of the corporation can be personally liable. None of the theories mentioned above is new.

Castleberry v. Branscum

In addition to the various claims mentioned above, another type of claim that can result in personal liability for an owner of a corporation is "piercing the corporate veil," sometimes called "disregarding the corporate fiction."[4] During the past decade, Texas law regarding "piercing the corporate veil" of limited liability has seen substantial changes. The catalyst of these changes

was *Castleberry v. Branscum*,[5] where the Texas Supreme Court approved a number of separate grounds for piercing the corporate veil to establish personal liability for an owner of a corporation. The Supreme Court described these grounds in this way: (1) where the corporate fiction is used as a means of perpetrating fraud;[6] (2) where the corporation is organized and operated as a mere tool or conduit of another corporation;[7] (3) where the corporate fiction is resorted to as a means of evading an existing legal obligation;[8] (4) where the corporate fiction is used to achieve or perpetuate a monopoly;[9] (5) where the corporate fiction is used to circumvent a statute;[10] (6) where the corporate fiction is relied upon as a protection of crime or to justify wrong;[11] and (7) where the corporation is undercapitalized.[12] The court also approved other grounds for imposing personal liability on owners of corporations, such as denuding.[13]

The Fifth Circuit has concluded that, although the *Castleberry* opinion lists seven different bases for piercing the corporate veil, these various bases can be grouped into three different grounds for piercing: alter ego, sham to perpetrate a fraud, and use of a corporation for an illegal purpose.[14] The "alter ego" ground is the second ground listed in the preceding paragraph (and in the *Castleberry* opinion), the "mere tool or conduit" ground.[15] The "illegal purpose" ground derives from the third, fourth, fifth, and sixth grounds set forth above.[16] The first, third, sixth, and seventh grounds form the basis of the "sham to perpetrate a fraud" claim.[17] Regardless of whether Texas courts accept this construction of *Castleberry*, it is clear that the Texas Supreme Court intended to approve alter ego and sham to perpetrate fraud as independent piercing grounds,[18] and many post-*Castleberry* cases have involved either an alter ego or sham to perpetrate a fraud claim.

Of the grounds approved in *Castleberry*, the theory of sham to perpetrate a fraud has received the most attention, at least in part because its contours are quite vague. In *Castleberry*, the court stated that to establish a sham to perpetrate a fraud, the plaintiff must prove constructive fraud, which was defined as "the breach of some legal or equitable duty ... which the law declares fraudulent because of its tendency to deceive others, to violate confidence, or to injure public interests."[19] At another part of the opinion, the court quoted approvingly from a treatise that "[sham to perpetrate a fraud is established] if recognizing the separate corporate existence would bring about an inequitable result."[20]

1989 Legislative Amendments

The corporate bar and its clients were less than thrilled with *Castleberry*. For example, a commentator noted, in an article written shortly after *Castleberry* was decided, that "*Castleberry* ... substantially broadens the grounds upon which a court may disregard corporate existence in a contract case."[21] Some commentators wondered whether *Castleberry* would discourage business activity in Texas. One case noted the "uproar" in the business community after *Castleberry* was decided.[22] Concerned parties drafted legislation to limit the scope of *Castleberry*.

The statute enacted in 1989 addressed grounds for piercing under Texas law. Before *Castleberry*, under Texas law it was more difficult to pierce the corporate veil for contract claims than tort claims.[23] This distinction was based upon the perception that contract claimants voluntarily assume the risk of dealing with a thinly capitalized entity, while tort claimants do not.[24] The amendment to Article 2.21 reintroduced this distinction into Texas law. The 1989 provision stated:

> A. A holder of shares .... shall be under no obligation to the corporation or its obligees with respect to:
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> (2) [A]ny contractual obligation of the corporation on the basis of actual or constructive fraud, or a sham to perpetrate a fraud, unless the obligee demonstrates that the holder, owner, or subscriber caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder, owner, or subscriber; or
>
> (3) [A]ny contractual obligation of the corporation on the basis of the failure of the corporation to observe any corporate formality, including without limitation: (a) the failure to

comply with any requirement of this Act of the articles of incorporation or bylaws of the corporation; or (b) the failure to observe any requirement prescribed by this Act or by the articles of incorporation or bylaws for acts to be taken by the corporation, its board of directors, or its shareholders.

The 1989 amendments did not specify whether they applied to causes of action that arose before the effective date of the statute. One appellate court determined that these amendments applied to causes of action that arose before the amendments were enacted.[25] Other appellate courts did not apply these amendments retroactively to appeals heard after the changes were effective, where the initial trial occurred before the amendments were enacted.[26]

The apparent intent of the 1989 revisions of Article 2.21 was to leave *Castleberry* intact regarding piercing claims made in connection with tort actions (more precisely, any type of claim other than a contract claim) against the corporation, but to limit grounds for piercing claims when the dispute stemmed from a contract dispute.[27] Somewhat surprisingly, cases decided after the 1989 amendments did not greatly clarify the applicable standards for piercing the corporate veil in contract disputes.

Some courts held that, after the 1989 amendments, a sham to perpetrate a fraud theory may no longer be used for piercing in a contract dispute.[28] In contrast, in a case decided by the Texas Supreme Court after the 1989 amendments, the court affirmed a piercing judgment based on a sham to perpetrate a fraud claim in a contract dispute.[29] It is unclear whether this decision (*Matthews Construction*) is based on the fact that the case was tried before the amendments to Article 2.21 were enacted,[30] or whether the Texas Supreme Court believed sham to perpetrate a fraud remained a tenable piercing ground in a contract dispute, even after the 1989 amendments.[31] Also, after the 1989 amendments, the Fifth Circuit affirmed a district court judgment permitting piercing in a contract dispute, based on a sham to perpetrate a fraud theory.[32]

Although the 1989 amendments to Article 2.21 state that non-compliance with corporate formalities can no longer be a ground for piercing in a contract dispute, some courts seem reluctant to embrace this portion of the statute. For example, in a 1990 case when the Texas Supreme Court was discussing factors relevant to a piercing determination in a contract case, the court included in a footnote a justification for considering compliance with corporate formalities.[33] Also, a recent court of appeals opinion states that, when determining whether alter ego exists in a contract dispute, compliance with corporate formalities is a factor.[34] After the 1989 amendments, other courts concluded that failure to comply with corporate formalities could not be considered in connection with a piercing claim based upon a contract.[35]

If it is accepted that evidence of non-compliance with formalities is not an appropriate ground for piercing in contract cases, a more general question is whether a claim of alter ego is possible in such cases. After the 1989 amendments, most courts concluded that an alter ego claim could still be made in a piercing case involving a contract dispute.[36]

It does appear that the drafters of the 1989 amendments attempted to prevent sham to perpetrate a fraud and constructive fraud as bases for a piercing claim in a dispute over a corporate contractual obligation. Some commentators argued that the effect of the 1989 amendments was broader. For example, one article concluded that a piercing claim for a corporate contractual obligation could only be based upon a showing of actual fraud.[37] This assumes a few things not clearly specified in the statute. First, the 1989 statute does not explicitly bar alter ego as an appropriate basis for piercing in a contract case; it only states that non-compliance with corporate formalities should not be considered as a basis for piercing. As mentioned above, most courts did not conclude that this provision barred alter ego as a ground for piercing in a contract case. In addition to the dispute over the viability of the alter ego ground in contract cases, no court has considered whether the statute restricts other grounds approved in *Castleberry* and not mentioned in the statute, such as denuding or undercapitalization. So, the 1989 amendments did not clearly delineate all effects on piercing in connection with contract claims.

The 1989 amendments did not affect *Castleberry* if the piercing claim arose from a claim against the corporation that was something other than a contractual obligation.[38]

1993 Legislative Amendments

In 1993, to clarify the Texas rules for piercing the corporate veil in contract cases, the Texas Legislature again amended Article 2.21 of the TBCA. The current version of Article 2.21 provides:

A. A holder of shares ... shall be under no obligation to the corporation or its obligees with respect to:

(2) any contractual obligation of the corporation on the basis that the holder, owner, or subscriber is or was the alter ego of the corporation, or on the basis of actual fraud or constructive fraud, a sham to perpetrate a fraud, or other similar theory, unless the obligee demonstrates that the holder, owner, or subscriber caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder, owner, or subscriber; or

(3) any contractual obligation of the corporation on the basis of the failure of the corporation to observe any corporate formality, including without limitation: (a) the failure to comply with any requirement of this Act or of the articles of incorporation or bylaws of the corporation; or (b) the failure to observe any requirement prescribed by this Act or by the articles of incorporation or bylaws for acts to be taken by the corporation, its board of directors, or its shareholders.

B. The liability of a holder, owner, or subscriber of shares of a corporation for an obligation that is limited by Section A of this article is exclusive and preempts any other liability imposed on a holder, owner, or subscriber of shares of a corporation for that obligation under common law or otherwise, except that nothing contained in this article shall limit the obligation of a holder, owner, or subscriber to an obligee of the corporation when:

(1) the holder, owner, or subscriber

has expressly assumed, guaranteed, or agreed to be personally liable to the obligee for the obligation; or

(2) the holder, owner, or subscriber is otherwise liable to the obligee for the obligation under this Act or another applicable statute.

Section 2.26 of the enacting legislation provides that the 1993 amendments apply to causes of action that arose before the amendments were adopted, unless the claim was finally adjudicated before the effective date of the act. It is not clear whether appellate courts will apply the 1993 law to appeals heard after the effective date of the law if the trial court judgment was entered before the effective date. For example, in *Western Horizontal Drilling, Inc. v. Jonnet Energy Corp.*[39] the plaintiff asserted an alter ego claim against a shareholder based on the corporation's contract debt. Before the effective date of the 1993 amendments, the trial court entered a judgment authorizing piercing. The judgment was appealed. The Fifth Circuit filed its opinion in early 1994, well after the effective date of the 1993 amendments. The opinion construes the 1989 amendments but does not mention the 1993 amendments.

In *Valley Mechanical Contractors v. Gonzales*[40] the plaintiff brought an alter ego claim trying to hold the corporation liable for a debt of the shareholder. In this case, the court affirmed the trial court piercing judgment based upon alter ego. The trial occurred in 1993; it is unclear whether the judgment was entered before the effective date of the 1993 amendments. The appellate opinion did not discuss whether the 1993 amendments applied to the case. The 1993 amendments state that they limit the liability of a *shareholder* for debts of the *corporation*; because the plaintiff here was trying to make the corporation liable for the debts of the owner, the court may have concluded that the statute did not apply.

Like the 1989 amendments, the 1993 amendments do not restrict any *Castleberry* piercing grounds for claims based on anything other than a contractual obligation. For all but contractual claims, alter ego and sham to perpetrate a fraud remain available.[41] It appears that the 1993 amendments expressly reject the notion that alter ego is a tenable ground for piercing in a contract dispute, if actual fraud cannot be established.[42]

The 1993 amendments have not totally clarified the rules in Texas regarding piercing for contract claims. Although the 1993 amendments expressly bar piercing based upon failure to comply with formalities, alter ego, sham to perpetrate a fraud, and constructive fraud, the statute does not expressly state whether any piercing grounds other than those expressly barred remain viable for contract claims. In subsection A(2), the statute does state that piercing based on alter ego, constructive fraud, sham to perpetrate a fraud, actual fraud, *or other similar theory*, should not be permitted unless actual fraud is established. Subsection B provides that liability of a shareholder for a claim limited under Subsection A is exclusive and preempts any other liability under common law. One group of authors has argued that the 1993 amendments were intended to clarify that a claim for piercing in a contract case could occur only if actual fraud is established.[43] It is unclear whether Texas courts will construe the statute in this manner. For example, in *King & Bumpous v. Foster*,[44] in connection with a breach of contract claim against a corporation owned by Foster, the plaintiffs alleged that Foster was personally liable due to, among other claims, denuding. Foster argued that the 1993 amendments barred a denuding claim in a contract dispute, unless actual fraud could be established. The court disagreed, holding that Article 2.21 only dealt with grounds for disregarding the corporate entity. The court perceived the *Castleberry* court's reference to denuding as distinguishing it from the various piercing grounds approved in that opinion;[45] because the court concluded that denuding is not a piercing ground, the claim was not barred by Article 2.21.[46]

Choice of Law

If a corporation and its owners have multistate contacts, choice of the applicable piercing law becomes an issue. Texas generally applies the "most significant relationship" test to conflict of laws issues.[47] In 1989, the Texas Legislature amended Art. 8.02 of the Business Corporation Act, which now provides that, as a general rule, the law of the state of incorporation applies to piercing claims. It is unclear whether Texas courts will apply this rule when the corporation has little or no contact with its state of incorporation and substantial contact with Texas.[48] For example, in *In re Guyana Development Corp.*[49] the court applied Texas law to determine the piercing claim, even though the corporations involved were incorporated elsewhere. Article 8.02 was not discussed.[50]

If courts apply Texas law to determine a piercing claim against a foreign corporation, the foreign corporation might not be given the same protection as that enjoyed by domestic corporations. The 1993 amendments insulate shareholders of "corporations" from personal liability for corporate debts. Corporation is defined in the code as excluding foreign corporations.[51]

Conclusion

Castleberry principles clearly apply to an attempt to pierce the corporate veil in connection with any tort claim.[52] Indeed, *Castleberry* applies in any situation other than a contract claim.[53] The picture is less clear regarding permitted piercing grounds in contract cases. Actual fraud clearly remains a viable theory in these cases; the 1993 amendments to Article 2.21 do not clearly state whether other grounds, such as denuding or inadequate capitalization, remain viable piercing grounds in such cases. Also, despite the amendments to Article 2.21, there may still be some confusion about the continued viability of both alter ego and sham to perpetrate a fraud in a piercing case arising from a contract dispute.

1. *See Dodds v. Charles Jourdan Boutique*, 648 S.W.2d 763 (Tex. App. — Corpus Christi 1983, no writ).
2. *See Grierson v. Parker Energy Partners 1984-I*, 737 S.W.2d 375 (Tex. App. — Houston [14th Dist.] 1987, no writ).
3. *See State v. Malone Service Co.*, 853 S.W.2d 82 (Tex. App. — Houston [14th Dist.] 1993, writ denied).
4. Piercing the corporate veil connotes holding the owner liable for claims against the corporation. It is also possible, in some circumstances, to hold the corporation

liable for claims against the owner; this is called "reverse piercing." *Zahra Spiritual Trust v. United States*, 910 F.2d 240 (5th Cir. Tex. 1990).

5. *See Castleberry*, 721 S.W.2d 270 (Tex. 1986).
6. *Id.* at 272.
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.*
11. *Id.*
12. *Id.* at 272, n.3.
13. *Id.* at 271, n.1.
14. *See Pan Eastern Exploration Co. v. Hufo Oils*, 855 F.2d 1106, 1130-1133 (5th Cir. Tex. 1988); *Fidelity & Deposit Co. v. Commercial Casualty Consultants*, 976 F.2d 272 (5th Cir. Tex. 1992).
15. *Pan Eastern*, 855 F.2d at 1132.
16. *Id.* at 1132.
17. *Id.* at 1133.
18. *See Castleberry*, 721 S.W.2d at 272-274.
19. *Id.* at 273.
20. *Id.* at 272-273.
21. James C. Chadwick, Corporations and Partnerships, 41 Sw. L.J. 201, 220 (1987).
22. *Farr v. Sun World Savings Ass'n*, 810 S.W.2d 294, 296 (Tex. App. — El Paso 1991, no writ).
23. *See Angus v. Air Coils, Inc.*, 567 S.W.2d 931, 933 (Tex. App. — Dallas 1978, no writ); *Hanson Southwest Corp. v. Dal-Mac Construction Co.*, 554 S.W.2d 712, 717 (Tex. App. — Dallas 1977, writ ref'd n.r.e.).
24. *See, e.g., United States v. Jon-T Chemicals, Inc.*, 768 F.2d 686, 692-93 (5th Cir. Tex. 1985), cert. denied, 475 U.S. 1014 (1986).
25. Farr, 810 S.W.2d at 294. *See also, Crum & Forster v. Monsanto Co.*, 887 S.W.2d 103 (Tex. App. — Texarkana 1994, writ requested).
26. *See Mancorp, Inc. v. Culpepper*, 802 S.W.2d 226 (Tex. 1990), on remand, 836 S.W.2d 844 (Tex. App. — Houston [1st Dist.] 1992); *Coastal Shutters & Insulation v. Derr*, 809 S.W.2d 916 (Tex. App. — Houston [14th Dist.] 1991, no writ).
27. *See Farr*, 810 S.W.2d at 294; *Crum & Foster*, 887 S.W.2d at 103; *In re Faith Missionary Baptist Church*, 174 B.R. 454 (Bankr. E.D. Tex. 1994). *See generally* Robert F. Gray. Jr. & Gregory J. Sergesketter, Annual Survey of Texas Law: Corporations, 45 Sw. L.J. 227 (1991).
28. *See Farr*, 810 S.W.2d at 294; *Western Horizontal Drilling v. Jonnet Energy Corp.*, 11 F.3d 65 (5th Cir. Tex. 1994). *See also, Crum & Forster*, 887 S.W.2d at 103. The House Research Organization bill analysis of the 1989 amendment stated that the bill was intended to bar piercing based on constructive fraud or failure to observe corporate formalities. House Research Organization, Bill Analysis, Tex. SB 1427, 71st Leg., R.S. (1989).
29. *Mathews Construction Co. v. Rosen*, 796 S.W.2d 692 (Tex. 1990).
30. This could stem from the "law of the case" doctrine, which provides that legal principles that govern a case should remain the same throughout the case. *See Hudson v. Wakefield*, 711 S.W.2d 628, 630 (Tex. 1986). The application of this doctrine is left to the discretion of the court. *See Kay v. Sandler*, 704 S.W.2d 430, 433 (Tex. App. — Houston [14th Dist.] 1985, writ ref'd n.r.e.).
31. For example, a recent Fifth Circuit opinion states that "the Texas Supreme Court seems to be ignoring the amendments to article 2.21...." *Western Horizontal Drilling*, 11 F.3d at 65, 69, n.5.
32. *Permian Petroleum Co. v. Petroleos Mexicanos*, 934 F.2d 635 (5th Cir. Tex. 1991).
33. *See Mancorp, Inc.*, 802 S.W.2d at 226, 229, n.2.
34. *See Coastal Shutters*, 809 S.W.2d at 916, 921.
35. *See Crum & Forster*, 887 S.W.2d at 103.
36. *See Western Horizontal Drilling*, 11 F.3d at 65; *Mancorp, Inc.*, 802 S.W.2d at 226; *Coastal Shutters*, 809 S.W.2d at 916.
37. Gray & Sergesketter, *supra* note 27, at 225, 226.
38. *See Western Horizontal Drilling*, 11 F.3d at 65, 68 n.4; Farr, 810 S.W.2d at 294.
39. *Western Horizontal Drilling*, 11 F.3d at 65.
40. 894 S.W.2d 832 (Tex. App. — Corpus Christi 1995, n.w.h.).
41. *See Watkins v. Black & Decker (U.S.)*, 882 F.Supp. 621 (S.D. Tex. 1995) (applying alter ego to a tort claim). *See also, Centeq Realty v. Siegler*, 899 S.W.2d 195 (Tex. 1995) (reaffirming the availability of the alter ego remedy in connection with tort claim).
42. *See Thrift v. Hubbard*, 44 F.3d 348 (5th Cir. Tex. 1995). *See generally* John D. Jackson & Alan W. Tompkins, Corporations and Limited Liability Companies, 47 SMU L. Rev. 901 (1994).
43. *See* Jackson & Tompkins, *supra* note 42, at 901, 919, n.161, 162 (summarizing remarks by Michael Tankersley).
44. No. 03-93-00314-CV (Tex. App. — Austin 1995, writ pending) (unreported).
45. For example, in *Castleberry* the court refers to denuding as an example of "other doctrines besides disregarding the corporate fiction." *Castleberry*, 721 S.W.2d at 271, n.1.
46. *See King & Bumpous v. Foster*, No. 03-93-00314-CV (Tex. App. — Austin 1995, writ pending) (unreported).
47. *See Duncan v. Cessna Aircraft Co.*, 665 S.W.2d 414 (Tex. 1984).
48. *See generally* J. Thomas Oldham, California Regulates Pseudo-Foreign Corporations — Trampling Upon the Tramps?, 17 Santa Clara L. Rev. 85 (1977).
49. 168 B.R. 892 (Bankr. S.D. Tex. 1994).
50. *See also, United States v. Clinical Leasing Services*, 982 F.2d 900 (5th Cir. La. 1992), where the court applied Louisiana law rather than the law of the state of incorporation to an alter ego claim because the court concluded that Louisiana had the most significant relationship with the dispute.
51. *See* Tex. Bus. Corp. Act Ann. art. 1.02A(7), 1.02A(9) (Vernon 1980 & Supp. 1995). For example, in *In re Guyana Development Corporation*, 168 B.R. at 892, 907, n. 28 the court stated that article 2.21 did not protect shareholders of foreign corporations.
52. *See, e.g., Stewart & Stevenson v. Serv-Tech*, 879 S.W.2d 89 (Tex. App. — Houston [14th Dist.] 1994, writ denied) (permitting alter ego claim in tort case).
53. *See Crum & Forster*, 887 S.W.2d at 103.

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